

OPENING STATEMENT

of

MICHAEL K. POWELL

Chairman

Federal Communications Commission

Before the

Subcommittee on Telecommunications and the Internet

of the House Committee on Energy and Commerce

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**SUMMARY OF OPENING STATEMENT OF
FCC CHAIRMAN MICHAEL K. POWELL
BEFORE THE
SUBCOMMITTEE ON TELECOMMUNICATIONS AND THE INTERNET
OF THE HOUSE COMMITTEE ON ENERGY AND COMMERCE
MARCH 29, 2001**

In order to serve the American public, the Federal Communications Commission, as an institution, must be efficient, effective, and responsive. The challenges of reaching these goals at the Commission are complicated by the sweeping, fast-paced changes that characterize the industries that we regulate. Indeed, the Commission is experiencing a challenge it has never faced: each industry segment in our portfolio is in the midst of revolution, and is attempting to adapt to the most fundamental changes in their history. Moreover, the changes are blurring the lines that once separated these industry groupings. There are new markets, new competitors, and new regulatory challenges.

For this agency to fulfill its congressional charge, indeed to remain relevant at all, it must write and execute a new business plan built along four dimensions: (1) a clear substantive policy vision, consistent with the various communications statutes and rules, that guides our deliberations; (2) a pointed emphasis on management that builds a strong team, produces a cohesive and efficient operation, and leads to clear and timely decisions; (3) an extensive training and development program to ensure that we possess independent technical and economic expertise; and (4) organizational restructuring to align our institution with the realities of a dynamic and converging marketplace.

My goal is to improve the agency on all these dimensions. To that end, I intend to seek the opinions and thoughts from a wide range of participants, including this Subcommittee and other Members of Congress and their staffs, as well as the businesses that come before the Commission. And, I want to hear from the Commission's employees. They often know best how we should change and what tools they need to do their jobs. I want to gather opinions and ideas, but be swift to make changes. It is our goal to fully complete many of these changes this year.

Finally, I will be turning to this Subcommittee and Congress for assistance. With regard to the organizational restructuring that is likely to be necessary, I hope you will concur in those changes. Most critically, I look to Congress to support the Commission's budgetary needs and objectives.

I cannot predict the future, nor can anyone else at the Commission. When faced with future challenges that are uncertain, the best approach is to build a first-class operation, with top talent, that is trained and disciplined enough to adapt quickly to new and changing situations. I hope to build, along with my colleagues and the outstanding FCC staff, just such a unit—one well suited to an uncertain future.

Good morning, Mr. Chairman and other distinguished members of the House Subcommittee on Telecommunications and the Internet. Thank you for inviting me here to discuss the Federal Communications Commission's agenda for 2001 and the agency's reform effort.

I am honored and humbled to lead the Commission at this time of unbelievable change in the communications industry. I believe a critical part of my job is to be a leader and steward of the agency, and I take this responsibility very seriously. In order to serve the American public, the FCC, as an institution, must be efficient, effective, and responsive. The challenges of reaching these goals at the Commission are complicated by the sweeping, fast-paced changes that characterize the industries that we regulate. Indeed, the Commission is experiencing a challenge it has never faced: each industry segment in our portfolio is in the midst of revolution, and is attempting to adapt to the most fundamental changes in their history—for example, competition and deregulation in telephones, DTV transition in television, modem and interactive services in cable, wireless Internet and digital services, consumer accessible satellite service, broadband everywhere, and on and on. Moreover, the changes are blurring the lines that once separated these industry groupings. There are new markets, new competitors, and new regulatory challenges. The game has become three-dimensional chess, where each board is spinning.

These winds of profound and dynamic change, unleashed in part by the Telecommunications Act of 1996, have buffeted the Commission and blown it into a position where its decisions have far-reaching impact on the future of communications, not only in the United States but throughout the world. We have come a long way from an agency where the principal focus was the assignment of radio licenses, and its principal activity was conducting lengthy comparative hearings to assign those licenses. This new environment is no longer linear, but chaotic and dynamic. For this agency to fulfill its congressional charge, indeed to remain relevant at all, it must put together a new business model and build the type of team that can execute it effectively. That is what we intend to do.

FCC Reform: The New Business Plan

I conceive of FCC reform as a comprehensive retooling and redirection of the Commission's entire mission. Our approach is to write and execute a new business plan built along four dimensions: (1) a clear substantive policy vision, consistent with the various communications statutes and rules, that guides our deliberations; (2) a pointed emphasis on management that builds a strong team, produces a cohesive and efficient operation, and leads to clear and timely decisions; (3) an extensive training and development program to ensure that we possess independent technical and economic expertise; and (4) organizational restructuring to align our institution with the realities of a dynamic and converging marketplace.

1. Substantive Vision

The industry, the capital markets, and the government find themselves navigating between the matured, legacy communications system and the nascent innovation-driven Internet space of the future. The legacy world to our back is a proud one. This nation built the finest voice communication system in the world, as well as top-notch mass media delivery systems in the form of radio, television, and cable. These systems have reached maturity though: that is,

we understand the basic technology and architecture; we largely understand the cost characteristics; and, we understand what the consumer wants and what the product is. And, government regulation and policy had coalesced around these understandings, principally in the form of regulated monopoly and oligopoly.

We now are looking up at a cresting wave of change that we are much less sure of how to navigate. The digital broadband world is in its infancy, and its qualities and characteristics are much less clear. The new advanced architectures and technologies are just beginning to be understood and deployed, with no clear winning technology or industry. The cost characteristics may differ substantially from those of traditional networks to which we are accustomed. Broadband Internet products are still being developed and we all wait to see what service offerings consumers will and will not embrace. It is a world of dynamic and chaotic experimentation in which any prediction of how it turns out is foolhardy.

I believe government policy needs to migrate steadily toward the digital broadband future, but remain humble about what it does not understand and cannot predict. I submit that this digital broadband migration should be built around incubation, innovation and investment. At the Commission, our policy direction will focus on this migration and will have several directional guideposts:

- We will do everything we can to facilitate the timely and efficient deployment of broadband infrastructure. In doing so, we will endeavor to promote the growth of a wide variety of technologies that can compete with each other for the delivery of content and will strive not to favor—or uniquely burden—any particular one.
- We will pursue the worthy universal service goals of ubiquity and affordability as new networks are deployed, but will challenge ourselves to do so in creative ways.
- We will redirect our focus onto innovation and investment. The conditions for experimentation and change and the flow of money to support new ventures have often been misunderstood or neglected. If the infrastructure is never invented, is never deployed, or lacks economic viability we will not see even a glimmer of the bright future we envision.
- We will harness competition and market forces to drive efficient change and resist the temptation, as regulators, to meld markets in our image or the image of any particular industry player.
- We will rationalize and harmonize regulations across industry segments wherever we can and wherever the statute will allow.
- We will validate regulations that constrain market activity that are necessary to protect consumers, or we will eliminate them.
- We will be skeptical of regulatory intervention absent evidence of persistent trends or clear abuse, but we will be vigilant in monitoring the evolution of these nascent markets.

- We will shift from constantly expanding the bevy of permissive regulations to strong and effective enforcement of truly necessary ones. We will need Congress' help to put real teeth into our enforcement efforts.

2. Operations and Management

All the vision in the world is useless if you do not build and manage an institution that can execute it. We intend to actively manage the agency. Indecision and avoidance are not legitimate policies and, thus, we will strive to reduce backlogs and put systems in place that will prevent them from returning. Managers will be measured, in part, on this basis.

The Commission will develop an annual strategic planning process that will be integrated with the federal budget cycle and the review of our performance as an institution and as individuals. We are working to establish uniform measures of productivity across the agency to facilitate this activity.

The Commission is developing a set of internal procedures that will allow it to function more smoothly. These procedures will cover subjects such as Commission deliberation, voting procedures and internal document security.

The Commission should continue to modernize its information technology infrastructure to ensure productivity gains. We must strive to be a virtual agency—one in which someone in Connecticut is able to access us as easily and readily as someone on Connecticut Avenue. We are working to make this goal a reality through increased electronic access capability. We are engaged in a time-consuming and expensive project, but one that is critical to our ability to remain relevant in this new millennium. We must continue with due speed to use the advances of technology to our advantage.

We have 18 major information technology systems that incorporate electronic filing or offer public access to data. The industry can file most license requests, equipment authorizations, and comments electronically. Seventy-two percent of our services have electronic filing capability, but I want to do better. We administered well over three million licenses last year, so it is critical that we are efficient in this area. It is also important that citizens all over America have the ability to contact us easily and from anywhere. Currently, they are able to do so electronically, by phone or the old fashioned way—by letter. Last year, we received well over one million inquiries from consumers. The public must be an active voice in the communications transformation, for they are the ultimate beneficiaries of the abundant choices resulting from full and fierce competition.

We are also overlaying this virtual agency concept to the benefit of FCC staff through an expansive telecommuting program, which is open to all eligible employees. Virtually 100 percent of the Commission's employees are eligible for the telecommuting program. Approximately 400 of our eligible employees, about 20 percent, have chosen to telecommute on either a regular or ad hoc basis. Fewer than one percent of those who wanted to telecommute have been turned down based on the Commission's criteria.

3. Technical and Economic Expertise

The communications revolution is being driven by advances in technology. The Commission must have a strong fluency in technology. We cannot depend on those we regulate for on-the-job tutorials while we make decisions. This situation is grave. Over the last six years, our engineering staff has decreased by more than 20 percent. Within the next four years, 40 percent of our engineering staff will be eligible to retire. Conversely, we are not replenishing the coffers at the other end by bringing in new employees. We, like other governmental departments and agencies, are competing for this talent in a tight labor market and are challenged to convince talent to enter government service. This has been most apparent trying to recruit entry level engineers at the GS-5 and GS-7 levels.

To address this situation the Commission is developing an agency-wide "Excellence in Engineering" program. We will examine creative ways to gain greater personnel and pay flexibility to attract technical talent. Increased salaries alone, however, will not do the trick, nor is it the sole motivator for anyone entering government service. We will look at ways to ensure technical workers are able to continue to develop in their field, through strong training and development programs and job rotation. Our laboratory facilities in Columbia, Maryland, need to be upgraded to provide engineers with the tools to engage in critical and challenging work. Improvement in this area will be difficult to achieve, but we consider it imperative to our efforts to improve our workforce.

It also is vital that we train our non-engineering staff in the areas of engineering and advanced technology. We already have begun to develop an FCC "university" of sorts using our own staff and guest lecturers, and taking advantage of various programs currently available through the government and local academic institutions. We can use this Washington, D.C. location to our advantage and tap into industry and academia. We can use local scholars and have them participate in an educational curriculum, to provide lectures, to provide classroom instruction, to provide counsel and advice. We need to take better advantage of our access to talent and knowledge.

I am putting similar emphasis on economics and market analysis. These tools are essential to our agency's mission. We have the opportunity to take advantage of both internal resources, visiting experts, and outside educational programs to help not only our economists improve their skills but to help all the FCC's employees understand better the impact of our rules on technological innovations, and competitive markets.

4. Restructuring

In addition to examining our systems and procedures, we need to look at the organizational structure of the agency. Communications policy has been written in carefully confined buckets premised on certain types of technology. The FCC's organizational structure largely mirrors that premise. But the convergence of technology tears down those traditional distinctions and makes it evermore difficult to apply those labels to modern communications providers. In the same way, it makes it more important than ever for us to examine whether those organizational buckets still hold water.

About a year ago, we began breaking down the technology-based divisions with the creation of the Enforcement Bureau and the Consumer Information Bureau. With those reorganizations, we created two bureaus aligned along functional responsibility. We created the Enforcement Bureau to improve the effectiveness of our enforcement activities in an increasingly competitive and converging market. We created the Consumer Information Bureau to enhance consumers' ability to obtain quick, clear and consistent information about communications regulations and programs. These changes have proven to be quite beneficial. As the industry moves toward fuller competition, the missions of these bureaus become even more critical. For consumers to take full advantage of the choices that competition brings, it is important that they have access to information that allows them to make an informed choice. Their ability to easily and quickly convey to us instances where the markets are not providing useful information to consumers in a particular circumstance or with a particular business is our early warning system for market failure or malfeasance on the part of industry players. While the consolidation of these functions is almost complete, there are some additional functions that are transferable into or out of those two bureaus.

We have undertaken a structural reorganization project that builds on some of the initial efforts of my predecessor, Chairman William E. Kennard. Our efforts will be guided by a few key objectives: (1) a functional organization designed along market lines, rather than technical ones; (2) a flatter substantive bureau structure; and (3) greater consolidation of key support functions.

Our program will proceed in phases. We have begun by systematically taking account of the agency's activities and functions to see what is working well and what is not. From that review we will produce a Phase I, short term, restructuring plan and a Phase II, longer range plan. The Phase II plan will consider what wholesale change is necessary and whether it is timely to move away even more from technology-based buckets. The question has been asked whether the Commission should be aligned along functional lines—e.g., enforcement, consumer information, spectrum management, licensing and competition—given increased convergence in the industry. This question deserves to be asked and answered. But first, we must seek additional and substantial information, and be completely satisfied that it is the right thing to do, before we move to rearrange substantially the organizational structure of the agency.

My goal is to improve the agency on all these fronts. An informed decision, however, is better than one based merely on supposition. I intend to seek the opinions and thoughts from a wide range of participants as we proceed down the path of reform. First, I look forward to working closely with this Subcommittee and other Members of Congress and their staffs. Second, I intend to hold forums to allow those that do business before us let us know how we can improve our processes and procedures. Third, I want to hear from the Commission's employees. They often know best how we should change and what tools they need to do their jobs. I want to gather opinions and ideas, but be swift to make changes. It is our goal to fully complete many of these changes this year.

I will be turning to you for assistance. With regard to the organizational restructuring that is likely to be necessary, I hope you will concur in those changes. Most critically, I look to Congress to support the Commission's budgetary needs and objectives. Please keep in mind that

we are largely a fee-based agency, where those who come before us pay for the services we render in the form of licensing and regulatory fees. We need to have the staff and other resources to provide those services efficiently, knowledgeably and decisively. Finally, I will look to this Subcommittee and Congress to help us expand our authority where necessary to bring about competition and to more effectively enforce our rules. For example, the authority given to us in Section 10 of the Communications Act to forbear from regulating when certain conditions are present has been quite helpful. I would like to be able to use that ability even more and would welcome the opportunity to work with you to explore whether that is feasible. Additionally, we need tougher penalties and longer statute of limitation periods if enforcement is to be more effective.

Conclusion

I cannot predict the future, nor can anyone else at the Commission. When faced with future challenges that are uncertain, the best approach is to build a first-class operation, with top talent, that is trained and disciplined enough to adapt quickly to new and changing situations. No army, for example, can know in advance what it will find when it engages on the battlefield. The fog and terror of war never afford the luxury of predictability. The key to success is to have a force that is well-trained in tactics, strategy and the weapons it will need. A force that is disciplined and able to adjust quickly and adapt to fluid conditions—threats and opportunities both will present themselves through the haze. I hope to build, along with my colleagues and the outstanding FCC staff, just such a unit—one well suited to an uncertain future.

Thank you. I would be happy to answer any questions this Subcommittee may have.



Progress on Point

TELECOM DEREGULATION, BROADBAND DEPLOYMENT AND ECONOMIC GROWTH

by Representative Billy Tauzin¹

The meltdown in the Information Technology ("IT") sector is of grave concern as we look forward to next year and the possibility of continuing this amazing economy and strengthening it as we enter a new administration. There are two areas that are going to make a huge difference in whether we can enlarge upon the strength of this economic expansion or whether we see the fear of a real downturn in the economy.

The first of the two areas concerns whether we have the courage, as quickly as possible in the next Congress, to enact real deregulation as contemplated by the Telecommunications Act of 1996. This area includes the topic of reform of the FCC. The second area concerns whether we are prepared to embark upon a very serious effort at reforming the energy policy laws of our country. What you see in California today, and what we're beginning to see in natural gas prices, not only in shortages that have developed in spot markets, but also in threats of brownouts and blackouts, has a tremendous effect upon the IT market.

It was none other than John Chambers, president and CEO of Cisco Systems, who explained to me that the dot-com marketplace is more energy-dependent than the old brick-and-mortar marketplace. He asked a simple question at one of our hearings: Did any of us know how much energy a simple laptop computer consumed on a daily basis? What was its share of the energy grid? None of us had an answer. He had one, of course. The answer was that a laptop computer consumes as much energy on a daily basis as the most energy-consuming item in your household, your refrigerator. The dot-com and IT sectors of our economy are actually energy guzzlers.

A growing dependence on foreign sources for our basic energy needs should tell us that we have an energy crisis looming that will directly and seriously impact what we have already, a "meltdown" in the IT sector. If we're going to rebuild the IT sector with competent and courageous deregulation, we are going to have to complement it with access to affordable energy. Hence, we need a prompt rewrite of national energy policy.

¹ This paper is adapted from remarks delivered by Representative W.J. (Billy) Tauzin (R-La.), at a Progress & Freedom Foundation conference on "Communications Deregulation and FCC Reform: Finishing the Job," held on December 8, 2000 in Washington, DC. Mr. Tauzin is Chairman of the House Committee on Energy and Commerce.

We are intent on making this new Congress one that will give real meaning to the deregulatory strains of the 1996 Telecom Act. In that regard, I want to address a topic that is dear to my heart, FCC reform.

The FCC, with its current structure and mission, is an anachronism built around the old ICC model of the last century. It is defined, run, organized, and postured around the super-regulatory models of the 1930s. If we in Congress have a mea culpa it is that in 1996 we failed then to do what we should have done: Rewrite the FCC into a pro-competitive model, built around the realities of the converging and merging marketplace of the Information Age upon which we have embarked.

Regulation of Comparable and Competitive Services

It is not enough to say that the FCC is structured badly. That is obvious. You have only to look at its bureaus to see that these distinct bureaus were built around an age when communications facilities and services were monopolies, providing distinct functional services in distinct geographical areas. That structure doesn't fit today's marketplace, when monopolies are falling, and competition is developing, and functional distinctions between the different delivery systems are becoming less and less relevant. Why should we have different regulation for broadband delivery on a satellite, as opposed to a cable, as opposed to a telephone DSL line, as opposed to a wireless delivery terrestrial system, if it's all the same product that is delivered to the consumer? Why should we regulate them differently, when, looking to the future, those services are common and competitive?

That question remains unanswered. Part of the answer is that we are living in a transition period, when telephone services are still regulated in the state and federal system as common carriage. We live in a transition when the traditional telephone services are fast colliding with new stage-three generation Internet services, and wireless services, and cable services that, over time, will provide as much voice as any telephone system formerly provided.

It is the transition period that has caused trouble because it has been managed by an agency with a 1930s structure and mentality. Revising the structure of the FCC is not the most difficult challenge. A new FCC chairman committed to revising the structure could do it without legislation. A new chairman could embark upon reorganization within the FCC. The real challenge will be in redefining the way the FCC operates, the way in which it either promotes deregulation or continues to embrace micro-management of the marketplace.

I'm a deregulator. The reason I came to Washington was to facilitate deregulation. I come from an energy state, and when I first came to Washington in 1980, the genesis of my interest in Washington was the fact that Representative John Dingell (D-MI) was writing policy to regulate the most important industries in my state. And, generally, to regulate them in a way that impacted negatively on employment, jobs, and economic opportunity. I

came to undo that, and we waged some enormous battles in those early 80's. Along with former Representative Tom Tauke (R-IA), I fought in that same period to deregulate broadcasters and transportation industries. In fact, over those years we began the process of deregulating the telecom sector.

I understand that in a transition period and in some marketplaces where, in fact, there is no competitive choice for consumers, regulations sometimes are necessary. And, regulations certainly are necessary in the areas of consumer protection and health and safety.

But regulations ought to be fairly and equally applied. If the FCC, for example, wants to regulate service providers under terms and conditions that the FCC determines to be in the public interest, it should propose a regulation. Let's debate it and then decide yes or no. If "yes", then apply the regulation to the range of similarly-situated competitors.

Personalized, Subjective Regulation

But in the last eight years the FCC and many like-minded agencies have embarked upon a new and more pernicious form of regulation. The FCC, for example, has used the process for considering applications for license renewals and license transfers associated with mergers to implement a form of personalized, subjective regulation, which borders upon unconstitutionality. What the FCC has said is that if you happen to have before us an application for license renewal or a transfer associated with a merger, or for whatever relief of any kind, you're in our room. We don't have any legislative timetable in which to act on your application. You're not coming out of that room until you agree to the conditions that we want to impose upon your particular application in this emerging, competitive marketplace.

Now, what could be more wrong than for a government agency to regulate single companies in a competitive marketplace in a differential way? And to accomplish this by requiring them to accept regulations "voluntarily". Once the applicants have accepted conditions "voluntarily" they are estopped from complaining in court that they've been regulated improperly. The court says, "but you accepted it, you voluntarily agreed to these 26 conditions, SBC." To whatever conditions, AOL-Time Warner, you're going to accept on your own business model before you go out of this little, dark room where we've been talking with you. So, you can't complain in court. You voluntarily accepted "personalized" regulation. As pernicious as this subjective new form of regulation is, it's doubly so because it denies the parties wronged the ability to go to court to make their case that they have been wronged and they are entitled to some judicial redress. We have got to address this.

Last year, Representative Richard Burr (R-NC) and Representative Charles Pickering (R-MS) put together a bill aimed at addressing the FCC's merger process. I hope not only to accomplish that initial reform, but to use it as a model for other agencies under

the jurisdiction of the Commerce Committee. What the bill says simply is that when applicants come before the FCC for a license renewal or merger approval the agency has a certain period of time in which to decide the case. I think we have 90 days in the bill. At the end of that 90-day period, the FCC must render a verdict of relief or no-relief. If it says "no", it must give written reasons that are judicially appealable. And, if it says "yes", it is forbidden to condition approval upon any "voluntary" conditions agreed upon by the applicant. That's a pretty simple and straightforward proposition, but it goes to the heart of what has been wrong with the way in which the FCC has managed this entire area of merger review.

FCC as a Taxing Authority

Secondly, the FCC has, as you know, been embarked on its own agenda. When you look at its charter, you see that it's an independent agency of government, subject to Congress. I've often said, if you looked at FCC Chairman William Kennard's web site, they left out the words: "subject to Congress." But the Commission has acted as a truly independent function of government, without regard to Congressional intent, oversight, or will. Too often, the Commission has set about on its own personalized agenda, whether it's low power radio, or restrictions on advertising, or even attempts to get into the quicksand of defining campaign finance reform by defining rights to free time on broadcasting.

That private agenda of the FCC extended eventually into a real blurring of the line between legislative, judicial, and executive authority. When the FCC gave us the E-Rate, a massive tax upon telephone consumers to carry out a building program in the education and hospital and library areas of our country, there was a blurring of all kinds of lines that our founding fathers attempted to draw in our basic structure of government. Here, the FCC is passing taxes; directing corporations to spend money without Congressional oversight and review, or appropriation; and, in fact, executively deciding who gets and who doesn't get the benefit of these dollars in a way that I believe offends the basic structure of our government.

Parameters Set by Congress

That sort of activity by the FCC has to stop. In reforming the FCC, we must define the mission of the FCC so that it operates within parameters defined by Congress. We are going to have to tackle the thorny issue of whether or not we continue to let the FCC do anything it wants under the guise of operating in the "public interest, convenience, and necessity." That's a pretty tough challenge. How do we redefine the authority and mission of the FCC so that it can accomplish its very useful and important work in spectrum management and in making sure that competition is fostered in the telecommunications marketplace, while at the same time not restricting the agency so much that it can't do its job?

To that end, Representative Paul Gilmore (R-OH) and I have filed a bill proposing a blue ribbon commission to work with GAO and provide recommendations not only on restructuring, but on remissioning, the FCC. A central question in terms of redefining the FCC's mission is a central question is: What should the agency be doing in this more competitive marketplace? What should be its central mission? If you look at the old mission, it was a regulatory mission. It was defined as such because we were faced with monopolies, and we were faced with the need for consumers to be protected from the abuses of those monopolies.

Now that we are moving more rapidly to open marketplaces, and merged and converged systems, what is the role of the FCC? How do we redefine that role in a way that gives it guidance in whatever parameters we set for it to act? How do we do it in a way that we assure that it will continue to be an agency that, in fact, will foster and, hopefully, influence the continued expansion of competitive choices for American consumers and a rebuilding of the IT marketplace this year and into the future.

Broadband Services

We are about to enter a new world of broadband services. As we enter that world, all the promises of merged and converged services in a package for Americans to choose from will be realized. Choices of delivery systems, whether wireless or wired, satellites or terrestrial, will become more and more available to American consumers. In that world, we're beginning to see the collision between the old regulatory structure and the unregulated computer and Internet world. As they collide, we're beginning to see some of the battle lines drawn.

In the AOL-Time Warner merger discussions, the open-access question frames the beginning of that debate. The open-access question is, essentially, a question of whether or not the new communications structures, built on broadband delivery systems, will be subject to any of the content control regulations and the price control, co-location, interconnection, and interoperability regulations that have defined the old world of telephone services. The open access question is just the beginning of that debate. But the manner in which we settle it in the next few years will define a future in which the Internet services built on this broadband platform either will be free from the old telephone world regulations or will inherit them.

It's my hope that this new administration under new leadership will lead us in the direction where, eventually, we can have unfettered and free competition in broadband, with consumers choosing from a wide variety not only of services, but of delivery platforms.

If we don't build very quickly upon the '95 Act, and complete the deregulation it envisioned as quickly as possible, we will continue to see meltdown in the IT sector. And we will begin to see new congressional interest in regulating price, terms, conditions, and

content of delivery in the new broadband services arena. We ought to rue that day. We ought to be deeply concerned that it will be upon us pretty soon if we don't act very quickly.

So, the challenge that we face next year is two-fold. One, to complete the deregulation of the '96 Act and to protect as much as possible the stirrings of free competitive choice in this marketplace. Two, to reform the FCC so it is actively associated with that new direction, rather than a direction looking to turn the clock back to 1930 and re-regulate in minute detail the provision of communications and electronic services for the American public.

The Challenge Ahead

That is a huge challenge, and I will again welcome and invite the help of The Progress & Freedom Foundation and others. We are prepared to do some very exciting things. How we come out of it all will be tempered by the fact that the Senate is so evenly divided. What we do is going to have to meet with broad bipartisan support and cooperation. It means that many of the proposals we make are probably going to have to be compromised in ways that I would prefer not to have to compromise.

But it means that we are going to be prepared to take the steps we need to restore the IT sector, to build back the progress toward deregulation, and to give this country an FCC that truly reflects the intent and purposes of the '96 Act. An FCC that is working day and night not to regulate, but to deregulate, and to create new and better forms of competitive services for the American public.

A private, non-profit, non-partisan law center established in 1993, The Progress & Freedom Foundation studies the impact of the digital revolution and its implications for public policy. It brings together a diverse group of thinkers and policy experts and shares their work with the American people through seminars, conferences, publications and electronic media of all kinds. Supported by tax deductible donations from corporations, foundations and individuals, PFF does not engage in lobbying activities or take positions on legislation.

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Cable Giants Block Rival Ads In Battle for Internet Customers

By SETH SCHIESEL

As the battle to provide high-speed Internet service heats up, the cable television giants are increasingly using a defensive tactic: refusing to sell advertising time to phone companies to promote D.S.L., an advanced telephone network technology that competes with cable modems.

From big markets like New York City, where Time Warner Cable has refused D.S.L. advertisements by the telephone company, Verizon Communications, to small towns like Newtown, Conn., cable companies are saying "thanks, but no thanks" as phone companies try to buy local advertising time to promote their high-speed service. D.S.L. -- or digital subscriber line service -- can deliver torrents of Internet data over normal phone lines.

No laws or regulations appear to bar cable companies from blocking advertisements from competitors. But combined with the cable carriers' strong market power, the advertising bans are raising concerns from some consumer advocates.

While magazines, newspapers and other media outlets routinely decline to sell advertising space to competitors, magazines and newspapers do not generally operate under government-granted franchises. As a result of those franchise privileges, most of the nation's households have only one choice for a cable television provider.

"This is blatantly anti-competitive behavior from companies that have been given preferential treatment by policy makers," said Gene Kimmelman, co-director of the Washington office of Consumers Union. "They have been given the right to control virtually all content on their cable systems, and they're misusing that power in an effort to undermine competition for new high-speed Internet services."

The telephone companies say that local cable advertising, from the standpoint of price and the audience reached, could be one of the most effective ways to promote D.S.L. to the relatively young, technically adept and affluent consumers most likely to sign up for high-speed Internet access. Viewers of ESPN's sports programming might be hot prospects, for example -- but only local market by local market. Verizon sells D.S.L. service only in scattered areas around the country, and so may want to take out ads on ESPN on the local cable systems in markets where it offers D.S.L. -- not on the national ESPN network itself.

Local television broadcast stations provide a possible alternative, especially since broadcast stations have no competitive reasons to refuse the D.S.L. ads. But broadcast ads tend to reach a more diffuse mass audience with potentially less appeal to the D.S.L. marketers.

"If you look at the 18-to-25-year-old segment, they are not spending a lot of time watching the major broadcast networks," said Jason B. Few, vice president for marketing for the Internet operation at SBC Communications Inc., one of the nation's largest telephone companies. "They have found other entertainment that they like on cable and that is an advertising medium that has been largely foreclosed to us."

Mr. Kimmelman of Consumers Union said his group intended to ask the Federal Trade Commission to investigate the issue soon. The F.T.C. declined to comment.

Although the market for residential high-speed Internet connections remains in its infancy, cable modems already hold a better than two-to-one lead over D.S.L. At the end of March, about 4.7 million homes used cable modems, compared with 2.2 million households with D.S.L. lines, according to the Yankee Group, a research and consulting firm in Boston. Fewer than 100,000 homes received high-speed, or broadband, connections from satellite providers.

The communications industry is always complicated, and there are many reasons cable modems have emerged as the most popular choice for broadband Internet service. Among them are the fact that cable modems are often faster and more reliable than D.S.L. and that cable companies took an early lead in deploying the equipment required to deliver Internet data at high speeds.

But as the big phone companies try to catch up, some of them are finding it more difficult to reach consumers than they may have expected.

"We've been forbidden, if you will, from being able to advertise D.S.L. on the cable networks as a competitive service to cable modems," said Mr. Few of SBC Communications, the company that so far has been most vocal on the issue. SBC is the local phone giant that does business in various parts of the country as Ameritech, Pacific Bell and Southwestern Bell.

SBC says that in the Southern California corridor between Los Angeles and San Diego, the company's D.S.L. advertisements have been refused by Cox Cable, Daniels Cablevision and Time Warner Cable. In Texas, SBC says the advertisements have been refused by Time Warner in Austin, Houston and San Antonio, where SBC is based. And besides being turned down by Charter Communications in Newtown, SBC, which owns Southern New England Telecommunications, has been refused by Comcast in Danbury, Conn.

And SBC says that on Tuesday, AT&T informed the company that it would not accept any D.S.L. advertisements in Chicago -- although AT&T has subsequently indicated that it might change its position, an SBC spokesman said. AT&T, the nation's largest cable company and long-distance carrier, has relatively small local telephone operations.

Verizon, the phone giant operating primarily in the Northeast but in many other parts of the country, too, said that in addition to Time Warner's refusal to run Verizon's D.S.L. advertisements in New York City, Comcast had refused such advertisements in Philadelphia, New Jersey and the Washington area. A Verizon spokesman did note that Comcast cable systems in Baltimore had accepted the advertisements and that AT&T had accepted them in Dallas.

The cable companies defend their decisions.

"We don't have any formal written company policy that says we won't accept D.S.L. advertising," said Amy Cohn, a spokeswoman for Cox, which had almost 600,000 cable modem subscribers at the end of

March. "But typically, we do not accept D.S.L. advertising because it is within our right to decide what advertising to carry on our cable networks."

A spokeswoman for Comcast declined to comment.

Lynn Yaeger, a spokeswoman for AOL Time Warner's cable operation, said, "the decision to accept or reject any request for advertising is made market by market for our company." A spokesman for AT&T's cable operation, the nation's biggest, also said that such decisions were made by local managers.

Anita Lamont, a spokeswoman for Charter Communications, the large cable operator based in St. Louis, said: "Charter doesn't have a formal corporate policy but in the case of the Newtown system, they felt very strongly, and were supported, in saying that this is the most direct competition to one of their core products and it would be cutting off their nose to spite their face to run it. So they chose not to."

BellSouth, the big local phone company in the Southeast, has not tried to advertise D.S.L. over local cable systems, according to a spokesman, instead preferring direct-mail solicitations and telemarketing.

A spokesman for Qwest Communications, the fourth of the big local phone carriers, said that Cox had refused D.S.L. advertisements in Phoenix but that AT&T allowed them in Denver, where Qwest is based.

For Dan Novak, vice president for programming and communications for Cox's San Diego operation, it is a matter of principle: "We routinely have taken the position of not taking advertising from our direct competitors. It's within our First Amendment rights. There are lots of other media outlets where they can advertise."

Organizations mentioned in this article:

Time Warner Cable; Verizon Communications

Related Terms:

Computers and the Internet; Telephones and Telecommunications; Advertising; Consumer Protection

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COMCAST PRESIDENT BRIAN L. ROBERTS ADDRESSES ECONOMIC CLUB OF WASHINGTON

[Print this Press Release](#)

Wednesday, January 24, 2001

Washington, D.C - In an evening address to the Economic Club of Washington, D.C., Comcast Corporation President Brian L. Roberts shared his vision of the continuing evolution of broadband communications and called on federal policy makers to "stay the course for success – stay focused on removing barriers to true, facilities-based competition and reducing regulation of competitors."

Roberts pointed to Comcast's leadership role in introducing digital cable and Comcast@Home high-speed Internet service. Comcast completed the year 2000 with over 1.35 million digital customers and over 400,000 cable Internet customers, in excess of company goals. With the completion of a series of recent acquisitions, Comcast is the cable provider for about 80 percent of homes in the Washington TV market.

"We are new to the Washington area," Roberts said, "and we are committed to bring a new level of service and satisfaction to cable customers in this region."

Roberts highlighted Comcast's investments in next-generation cable systems in greater Washington, totaling in excess of \$250 million. He demonstrated new services that customers can expect as a result of these upgrades, including digital cable with nearly 250 channels of crystal-clear pictures; the Comcast@Home high-speed Internet service; video-on-demand, which the company will begin to deploy in select markets during 2001; and other products.

Roberts attributed the recent growth and success of Comcast and the cable industry to the bipartisan 1996 Telecommunications Act. The Act established a federal policy of removing barriers to competition accompanied by deregulation of increasingly competitive markets. "This policy has really worked, especially in the video and broadband markets," Roberts said.

However, Roberts pointed to disturbing signs that there will be efforts to undercut these successful policies. "We are hearing more and more talk of 'regulatory parity' from some quarters," Roberts said. "What we should be talking about is 'deregulatory parity'.

"The right approach is to find ways to deregulate established players, like the telephone companies, as they invest in new competitive markets like broadband, being careful not to do so in ways that entrench their dominance in local telephone service," Roberts said.

"The wrong approach is to 'level the playing field' by forcing new competitors like cable, satellite and wireless into regulatory modes designed for old-style monopolies. This would be certain to stifle competition and investment by cable and others, and will only help those who really don't want to invest and compete."

Roberts promised that Comcast would be "a good and active corporate citizen" in the Washington area. He pointed to the company's commitment to high-quality local video programming and its many initiatives to use cable technology to improve education and opportunity for young people.

Roberts noted that Comcast has already provided free high-speed cable Internet connections to over

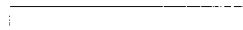
1,000 schools and libraries, and will ultimately wire 750 more in the Washington area. He also announced Comcast's commitment to train teachers in effective classroom use of the Internet – "one of the greatest needs that we have identified" – and said that over 1,000 teachers had already signed up for training in Montgomery County alone.

Roberts said that Comcast is "proud to be your local cable company. We are energized by the challenge of making cable in this area the best anywhere. We are pleased to be your corporate neighbor and colleague. And, as our company credo says, we hope to be the company that you will turn to first to connect with what's important in your life."

About Comcast:

Comcast Corporation (www.comcast.com) is principally involved in the development, management and operation of broadband cable networks, and in the provision of electronic commerce and programming content. Comcast Cable is the third largest cable company in the United States and, incorporating pending cable transactions, will serve more than 8.4 million subscribers. Comcast's commerce and content businesses include majority ownership of QVC, Comcast-Spectacor, Comcast SportsNet, and The Golf Channel, a controlling interest in E! Entertainment Television, and other programming investments. Comcast's Class A Special and Class A Common Stock are traded on The Nasdaq Stock Market under the symbols CMCSK and CMCSA, respectively.

[Print this Press Release](#)



UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(Mark One)

☒ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2000

OR

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number: 333-59399

Rhythms NetConnections Inc.

(Exact name of registrant as specified in its charter)

Delaware

33-0747515

(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer Identification No.)

5100 East Mineral Circle
Englewood, CO

80112
(Zip Code)

(Address of principal executive offices)

Registrant's telephone number, including area code: (303) 418-2000

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of exchange on which registered
None.	None.

Securities registered pursuant to section 12(g) of the Act:
Common Stock, par value \$.001 per share
(Title of Class)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period as the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form-10K or any amendment to this Form 10-K. ☒

The aggregate market value of voting common equity held by non-affiliates of the Registrant was approximately \$115,385,888. This calculation is based upon the close price of such common equity on February 2, 2001 of \$1.94 and the number of shares held by non-affiliates, which was 59,482,471 shares on December 31, 2000. As of December 31, 2000, the number of outstanding shares of the Registrant's (1) \$.001 par value Common Stock (Common Stock) was 79,739,764; (2) \$.001 par value 1/4% Series E Convertible Preferred Stock due 2013 was 250,000; (3) Series I Junior Participating Preferred Stock was 0; and (4) \$.001 par value 6 3/4% Series F Cumulative Convertible Preferred Stock was 2,000,000.

CAUTIONARY NOTE ABOUT FORWARD-LOOKING STATEMENTS

All statements contained herein that are not statements of historical fact constitute "Forward-Looking Statements" within the meaning of Section 27A of the Securities Act of 1933, as amended (Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (Exchange Act). Such forward-looking statements involve known and unknown risks, uncertainties and other factors that could cause our actual results to differ materially from historical results or from any future results expressed or implied by such forward-looking statements. Readers are urged to consider statements that include the terms "believe," "belief," "expects," "plans," "anticipates," "intends" or the like to be uncertain and forward-looking. Forward-looking statements also include projections of financial performance, statements regarding management's plans and objectives and statements concerning any assumptions relating to the foregoing. For a discussion of developments since December 31, 2000, see "Developments Since December 31, 2000" below.

The fiscal years ended December 31, 1997, 1998, 1999 and 2000, and the fiscal year ending December 31, 2001, are referred to herein as "1997," "1998," "1999," "2000" and "2001," respectively.

PART 1

Item 1 - Business

Formed in February 1997, Rhythms NetConnections Inc. (the Company) is a leading provider of broadband local access communication services. Our services include a range of high-speed, "always on" connections that offer our customers both cost and performance advantages when accessing the Internet or private networks. We use multiple digital subscriber line (DSL) technologies to provide data transfer rates ranging from 128 kbps to 8.0 Mbps delivering data to the end user and from 128 kbps to 1.5 Mbps receiving data from the end user.

Our customers include large enterprises, telecommunication carriers and their Internet service provider (ISP) affiliates and other ISPs. Enterprise customers typically purchase our services indirectly from our telecommunications carriers or directly from us to provide employees, branch offices and other affiliates with high-speed remote access to the enterprise's local and wide area networks (LAN or WAN). Telecommunications carriers and their ISP affiliates typically purchase our services for resale to business and consumer customers. ISPs typically purchase our services to provide high-speed Internet access to their business and consumer end users.

As of December 31, 2000, we offered our services in 60 markets in the United States (U.S.) representing 97 of the largest metropolitan statistical areas (MSAs). We believe we have one of the nation's largest DSL networks with approximately 1,850 built or operational central offices (COs).

In January 2001, we announced that, although we intended to maintain a physical presence in all 60 markets and 1,850 COs, we planned to focus on, and provide services in, only our top 40 markets, representing approximately 1,400 COs. We continue to review the number of markets we are in, the number of COs we operate, the size of our work force and our other selling, general and administrative (SG&A) costs with a view to conserving cash and enhancing our ability to achieve future profitability.

As of December 31, 2000, we had approximately 67,000 DSL lines in service.

the ILEC has met a "checklist" showing that it is meeting the 1996 Act's requirements in opening its network and markets to competition. The 1996 Act requires traditional telephone companies, among other things, to:

- . allow CLECs to lease copper telephone lines on a line-by-line basis;
- . provide CO space for the CLECs' DSL and other equipment used to connect to the leased copper telephone lines;
- . lease access on their CO fiber backbone to link the CLECs' equipment; and
- . allow CLECs to use their operational support systems to place orders and access their databases.

The FCC, in interpreting the 1996 Act, has emphasized the need for competition-driven innovation in the deployment of advanced telecommunications services, such as DSL services.

Line sharing

The FCC mandated "line sharing" in a November 1999 decision that became effective in June 2000. Line sharing, where available, will allow us to provide our RADSL service on the same copper telephone lines as the ILEC uses to provide its voice service. In January 2001, the FCC clarified its mandate, permitting CLECs to provide line sharing over fiber facilities and allowing CLECs also to line share with voice competitors. Some details of implementation of this mandate may be reconsidered by the FCC and both the original line sharing decision and the clarification are currently on judicial appeal before the D.C. Circuit. The decisions of the D.C. Circuit or of the U.S. Supreme Court on these issues could materially adversely affect our business and financial prospects.

State regulation

Some of our services, particularly those of Linkx and Linkx VA, may be classified as intrastate services subject to state regulation. All of the states where we operate, or will operate, require some degree of state regulatory commission approval to provide certain intrastate services. In most states, intrastate tariffs are also required for various intrastate services, although we are not typically subject to price or rate of return regulation for tariffed intrastate services. Actions by state PUCs could cause us to incur substantial legal and administrative expenses.

Under the 1996 Act, states have undertaken or completed regulatory proceedings to determine the pricing of unbundled network elements and services, and the results of these proceedings will determine the price we pay for, and whether it is economically attractive for us to use, these elements and services.

We are subject to requirements in some states to obtain prior approval for, or notify the state commission of, any transfers of control, sales of assets, corporate reorganizations, issuances of stock or debt instruments and related transactions. Although we believe such authorizations could be obtained, there can be no assurance that the state commissions would grant us authority to complete any transactions.

Competition

Competition for broadband access services is intense. We face competition from many competitors with significantly greater financial resources, well-established brand names and large, existing installed customer bases. Moreover, we expect the level of competition to increase in the future. We expect significant competition from:

ILECs. All of the ILECs in our target markets offer DSL services. As a result, the ILECs represent our strongest competition in all of our markets, and we expect this competition to intensify. The ILECs have well-established brand names and reputations, possess significant capital and own the COs and copper telephone lines. Importantly, they are offering both digital data services and their existing voice services over a single line to achieve a lower cost per line per month than we can. In addition, some ILECs are modifying their networks by deploying fiber further into neighborhoods and placing DSL electronics in these neighborhoods. Unless we can achieve equivalent access to these locations and these services, the ILECs will have a significant advantage to providing DSL under the new architecture.

Traditional and Newer IXCs. Many of the leading traditional and newer IXCs are rapidly expanding their networks to include high-speed, local access services, and/or acquiring other companies with high-speed, local access capabilities, including cable modem. They also have interconnection agreements with the ILECs and may have secured collocation spaces from which they may have begun to offer competitive DSL services. When combined with their extensive existing MANs and WANs, and full range of Internet and private networking services, they are able to provide their customers with a complete broadband communications offer capable of voice, data and video solutions. Because these competitors have significantly greater financial resources, enjoy strong brand recognition and have large, existing business and consumer franchises, they represent significant competition.

Cable Modem Service Providers. Cable modem service providers and their cable partners are offering high-speed Internet access over hybrid fiber coaxial cable networks to consumers and, increasingly, businesses. These networks provide Internet access services similar to our services, and in some cases at higher speeds. In certain cases cable modem services are priced lower than our services partly because operators share the bandwidth available on their cable networks among multiple end users.

ISPs. ISPs provide Internet access to residential and business customers. These companies provide such Internet access, on a dial-up basis, over the ILECs' circuit-switched networks at ISDN speeds (either 64 kbps or 128 Kbps) or below. Many ISPs also offer DSL-based access using their own DSL services, or DSL services offered by the ILECs or other DSL-based CLECs. Because certain large, national ISPs have made investments in our competitors and entered into joint marketing arrangements nationwide, it is difficult for us to recruit these ISPs as customers, and as a result, they represent important competitors.

Online Service Providers. Online service providers include companies that provide, over the Internet and/or over proprietary networks, content and applications ranging from news and sports to consumer video conferencing. These services are designed for broad consumer access over telecommunications-based transmission media, which enable the provision of digital services to the significant number of consumers who have personal computers with modems. Many of these online service providers have developed their own access networks for modem connections. If these online service providers were to extend their access networks to include DSL or other high-speed service technologies, they would become competitors of ours.

CLECs. Certain national CLECs offer DSL-based broadband access services using a business strategy similar to ours. In addition, regional CLECs offer DSL-based access services that compete with the services we offer.

Wireless and Satellite Data Service Providers. Wireless and satellite data service providers are developing wireless and satellite-based Internet and private network connectivity.

Strategic Investments in 2000

During 2000, we, directly or indirectly, through one or more of our wholly-owned subsidiaries, made the following strategic investments:

- effectively manage multiple relationships with our customers, suppliers and other third parties.

We may not be able to install operational support systems or management information and control systems in an efficient and timely manner, and our current or planned personnel, systems, procedures and controls may not be adequate to support our future operations. Failure to manage our future growth effectively could adversely affect the expansion of our customer base and service offerings. Any failure to successfully address these issues could materially and adversely affect our Business.

Our need for additional funding may restrict our future growth. For example, while in January 2001, we announced that, although we intended to maintain a physical presence in 50 markets, we planned to focus on, and provide services in, only our top 40 markets, and we continue to review the number of markets we are in, the number of COs we operate, the size of our work force and our other SG&A costs with a view to conserving cash and enhancing our ability to achieve future profitability.

The telecommunications industry is undergoing rapid technological change, and new technologies may be superior to the technology we use.

The telecommunications industry is subject to rapid and significant technological changes, such as continuing developments in DSL technology and alternative technologies for providing high-speed data communications. We cannot predict the effect of technological changes on our business. We will rely in part on third parties, including certain of our competitors and potential competitors, for the development of and access to communications and networking technology. New products and technologies that develop in our market may be superior to and/or render obsolete the products and technologies that we currently use. Our future success will depend, in part, on our ability to anticipate and adapt to technological changes and evolving industry standards. We may be unable to obtain access to new technology on acceptable terms or at all, and we may be unable to adapt to new technologies and offer services in a competitive manner. Our joint development projects and our strategic arrangements may not produce useful technologies or services for us. Further, new technologies and products may not be compatible with our technologies and business plan. In addition, many of the products and technologies that we intend to use in our network services are relatively new and unproven and may be unreliable. See also Competition: ILECs above.

Our success depends on our retention of certain key personnel and on the performance of those personnel.

Our success depends on the performance of our officers and key employees. Members of our senior management team have worked together for only a short period of time. We do not have "key person" life insurance policies on any of our employees nor do we have employment agreements for fixed terms with any of our employees. Any of our employees, including any member of our senior management team, may terminate his or her employment with us at any time. Our future success also depends on our continuing ability to identify, hire, train and retain highly qualified technical, sales, marketing and customer service personnel. Moreover, the industry in which we compete has a high level of employee mobility and aggressive recruiting of skilled personnel. We may be unable to continue to employ our key personnel or to attract and retain qualified personnel in the future. We have entered into retention arrangements with most, but not all, of our senior managers and other key personnel. There can be no assurance that these programs will be successful in retaining such senior managers and/or key employees.

Uncertain federal and state tax and other surcharges on our services may increase our payment obligations.

Telecommunications providers pay a variety of surcharges and fees on their gross revenues from interstate and intrastate services. The division of our services between interstate and intrastate services is a matter of interpretation, and in the future the FCC or relevant state commission authorities may contest this division.

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, DC 20549

FORM 10-Q

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2001

000-25271
(Commission file number)

COVAD COMMUNICATIONS GROUP, INC.
(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction
of incorporation or organization)

77-0461529
(U.S. Employer
Identification Number)

4350 Burton Drive
Santa Clara, California
(Address of principal executive offices)

95054
(Zip Code)

(408) 987-1000
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

As of June 15, 2001 there were 174,958,511 shares outstanding of the Registrant's Common Stock, including Class B Common Stock.

In addition, we may wish to selectively pursue possible acquisitions of or investments in businesses, technologies or products complementary to ours in order to expand our geographic presence, broaden our product and service offerings, and achieve operating efficiencies. We may not have sufficient liquidity, or we may be unable to obtain additional debt or equity financing on favorable terms or at all, in order to finance such an acquisition or investment.

As noted above, we received a notice of default and acceleration claim from a group of our convertible noteholders who claim that our restatement of our unaudited interim financial statements for a previously reported quarter in 2000 is a default under our convertible notes indenture. These noteholders also claim that this default cannot be cured and is grounds for acceleration of the entire amount owed on their convertible notes. We have disputed this notice and we believe that the probability of this contention prevailing, if it is litigated, is remote.

We believe that our current cash, cash equivalents and short-term investments will be sufficient to meet our anticipated cash needs for working capital and capital expenditures into the second quarter of 2002. An adverse judgment in the securities litigation or the noteholder litigation, the granting of the attachment requested in the noteholder litigation, the continued deterioration of the ability of our customers to pay for our services or other adverse business, legal, regulatory or legislative developments would accelerate the time at which we would need additional capital. If necessary, we will develop a contingency plan to address any material adverse developments arising in the securities and noteholder litigation. We also recognize that we will be required to raise this additional capital at times and in amounts which are uncertain, especially under the current capital market conditions. If we are unable to acquire additional capital or are required to raise it on terms that are less satisfactory than we desire, it will have a material adverse effect on our financial condition, which could require a restructuring, sale or liquidation of the Company.

Risk Factors

The following is a summary list of some of the risk factors relating to our Company. For additional detail regarding these and other risk factors, please refer to "Part I, Item 1. Business—Risk Factors," found in our Annual Report on Form 10-K, filed with the SEC on May 24, 2001.

- Our ability to continue as a 'going concern' is uncertain
- We face possible delisting from the NASDAQ National Market, which could result in a limited market for our common stock
- We have received a notice of default from some of the holders of our convertible notes relating to the late filing of this report on Form 10-Q for the first quarter of 2001
- We have received a notice of default and acceleration claim from some of our noteholders based on the adjustments that we made to our unaudited financial statements for a previously reported quarter in 2000
- Our leverage is substantial and will increase, making it more difficult to respond to changing business conditions
- Holders of our convertible notes have filed a motion to attach approximately \$100 million of the proceeds from our convertible notes offering
- Our rapid growth exacerbated weaknesses in our internal controls, which the Company is currently addressing
- We must raise additional capital under very difficult market conditions in order to continue our growth and maintain current operations
- Our business will suffer in a variety of ways unless financial market conditions improve

- The financial uncertainty of the DSL industry is causing us to lose orders
- Our failure to manage our growth effectively may hurt our ability to achieve profitability and positive cash flow from our operations
- We are dependent on a limited number of customers for the preponderance of our revenues, and we are highly dependent on sales through our resellers
- We are a party to litigation and adverse results of such litigation matters could negatively impact our financial condition and results of operations
- We will require a significant amount of cash to service our indebtedness; our ability to generate cash depends on many factors beyond our control
- We rely upon distributions from our subsidiaries to service our indebtedness and our indebtedness is effectively subordinated to the indebtedness of our subsidiaries
- The price of our common stock may fluctuate significantly, which may result in losses for investors
- Future sales or issuance of our common stock may depress our stock price
- Anti-takeover effects of certain charter and bylaw provisions, Delaware law, our indentures, our Stockholder Protection Rights Plan and our change in control severance arrangements could prevent a change in control
- We may experience decreasing margins on the sale of our services, which may impair our ability to achieve profitability or positive cash flow
- The markets we face are highly competitive and we may not be able to compete effectively, especially against established industry competitors with significantly greater financial resources
- Our business is difficult to evaluate because we have a limited operating history
- We have a history of losses and expect losses in the future
- Our operating results are likely to fluctuate in future periods and may fail to meet expectations of securities analysts and investors
- We cannot predict whether we will be successful because our business strategy is largely unproven
- Our services are subject to government regulation, and changes in current or future laws or regulations and the methods of enforcing the law and regulations could adversely affect our business
- Charges for unbundled network elements are generally outside of our control because they are proposed by the traditional telephone companies and are subject to costly regulatory approval processes
- Challenges in obtaining space for our equipment on premises owned by the traditional local telephone companies harm our business
- The failure of traditional telephone companies to adequately provide transmission facilities and provision telephone wires is likely to impair our ability to install lines and adversely affect our growth rate
- Challenges in obtaining the overall cooperation of the traditional telephone companies harm our business
- Our business will suffer if our interconnection agreements are not renewed or if they are modified on unfavorable terms
- Our success depends on our retention of certain key personnel, our ability to hire additional personnel and the maintenance of good labor relations
- We depend on a limited number of third parties for equipment supply, service and installation

- We have made and may make acquisitions of complementary technologies or businesses in the future, which may disrupt our business and be dilutive to our existing stockholders
- The broadband communications industry is undergoing rapid technological changes, and new technologies may be superior to the technology we use
- A system failure could delay or interrupt service to our customers
- A breach of network security could delay or interrupt service to our customers
- Interference in the traditional telephone companies copper plant could degrade the performance of our services
- Our intellectual property protection may be inadequate to protect our proprietary rights
- We must comply with federal and state tax and other surcharges on our service, the levels of which are uncertain

Forward-Looking Statements

The statements contained in this Report on Form 10-Q that are not historical facts are "forward-looking statements" (as such term is defined in Section 27A of the Securities Act and Section 21E of the Exchange Act), which can be identified by the use of forward-looking terminology such as "estimates," "projects," "anticipates," "expects," "intends," "believes," or the negative thereof or other variations thereon or comparable terminology, or by discussions of strategy that involve risks and uncertainties. Examples of such forward-looking statements include but are not limited to:

- expectations regarding the extent to which enterprise customers roll out our service;
- expectations regarding our relationships with our strategic partners;
- expectations as to pricing for our services in the future;
- expectations as to the impact of our service offerings on our margins;
- the possibility that we may obtain significantly increased sales volumes;
- the impact of our national advertising campaign on brand recognition and operating results;
- plans to make strategic investments and acquisitions and the affect of such investments and acquisitions;
- estimates and expectations of future operating results, including expectations regarding our monthly cash burn rate and the number of installed lines;
- expectations regarding the time frames, rates, terms and conditions for implementing "line sharing;"
- plans to develop and commercialize value-added services;
- projections of the amount of additional capital required to fund our business;
- our anticipated capital expenditures;
- plans to enter into business arrangements with broadband-related service providers;
- expectations regarding the development and commencement of our voice services;
- our ability to manage relationships with our bondholders;
- the effect of regulatory reform and securities and regulatory litigation;
- the effect of other litigation currently pending; and
- other statements contained in this Report on Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2000, regarding matters that are not historical facts.